

Appeal from a decision of the Director, Minerals Management Service, affirming letter-order requiring payment of additional royalties for gas produced from Outer Continental Shelf oil and gas leases. MMS-80-0153-OCS.

Reversed in part; set aside in part and remanded.

1. Oil and Gas Leases: Royalties--Outer Continental Shelf Lands Act: Oil and Gas Leases

The Department is not bound by 30 CFR 250.64 (1979) to value production for royalty purposes according to the contract price. However, when a lessee computes royalty for gas sold under a contract according to the contract price and the Government accepts that valuation, yet rejects that same valuation for unregulated gas transferred to the lessee's refinery under a firm transportation agreement with the contract buyer, such a rejection is improper where the facts show that, in the absence of being transferred to lessee's refinery, such gas would have been required to have been sold to the same buyer according to the same contract price accepted by the Government.

APPEARANCES: Patrick J. Butler, Esq., Wendy F. Daboval, Esq., and Lowell N. Elsen, Esq., New Orleans, Louisiana, for appellant; Peter J. Schaumberg, Esq., Geoffrey Heath, Esq., and Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, Washington, D.C., for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE HARRIS

Texaco, Inc. (Texaco), has appealed from a decision of the Director, Minerals Management Service (MMS), dated June 27, 1986, affirming a November 23, 1979, letter-order by the Oil and Gas Supervisor, Accounting, Gulf of Mexico Area, requiring the payment of certain additional royalties for gas produced during a period of years from oil and gas leases OCS-0572, OCS-0575, OCS-0578, and OCS-0788 and transported by the Transcontinental Gas Pipe Line Corporation (Transco) to Texaco's Eagle Point refinery. Texaco's leases were issued pursuant to the Outer Continental Shelf Lands Act (OCSLA), as amended, 43 U.S.C. || 1331-1356 (1976).

The record indicates that Texaco entered into two gas purchase contracts with Transco on December 8, 1969, one for the sale of gas produced from leases OCS-0572, OCS-0575, OCS-0578, situated in Block 208 Field, Eugene Island Area, and the other for lease OCS-0788, located in Block 48 Field, South Marsh Island Area, Gulf of Mexico. Under the contracts, Texaco agreed to sell and Transco agreed to purchase a minimum quantity of gas subject to reduction by that volume of gas which Texaco elected to deliver to Transco for transportation on a firm basis to Texaco's Eagle Point, New Jersey, refinery (Eagle Point gas), pursuant to a previous transportation agreement between Texaco and Transco. 1/ The contracts established certain prices for the sale of gas, but provided that the price would be increased to whatever just and reasonable area ceiling rate might be prescribed or approved by the Federal Power Commission (FPC) or any successor Governmental authority for like-quality gas, whenever that rate exceeded the established price.

On November 16, 1979, the Office of the Inspector General (OIG), U.S. Department of the Interior, issued a report (Audit Report), which constituted a review of royalties paid by Texaco for gas produced from OCS leases OCS-0572, OCS-0575, and OCS-0578 for the period August 1972 through July 1978 and from OCS lease OCS-0788 for the period January 1974 through July 1978, and either sold or delivered to Transco. Based upon its review, OIG concluded, inter alia, that Texaco had underpaid royalties in the amount of \$339,183.22 due to incorrect valuation of Eagle Point gas and recommended assessment of that additional royalty. OIG noted that, during the audit period, Texaco had sold 15,857,637 thousand cubic feet (Mcf) of gas to Transco and delivered 20,267,845 Mcf of gas to Transco for transportation to Texaco's Eagle Point refinery, 2/ and that, in both cases, Texaco had valued the gas for royalty computation purposes according to the price set by the December 1969 gas purchase contracts. 3/ Applying 30 CFR 250.64 (1979), OIG concluded that Texaco had correctly valued gas sold to Transco, but that Texaco should have valued gas delivered to Transco for transportation to Texaco's Eagle Point refinery "on the basis of the highest obtainable interstate price if each month's production had been offered as a separate or new sale" (Audit Report at 6). The basis for OIG's conclusion that the "highest obtainable interstate price" constituted the appropriate value was that Texaco was not legally committed to deliver any gas to its Eagle Point refinery and, thus, had the option of selling such gas on the interstate

1/ Texaco committed to the two gas purchase contracts its interest in recoverable gas reserves in all formations underlying the four leases down to a vertical depth of 15,000 feet below mean sea level. The contracts stated that any portion of the reserves made available for transportation on a firm basis to Texaco's Eagle Point refinery would not be considered committed under the contracts.

2/ Of the gas transported to Texaco's Eagle Point refinery, MMS reports that 900,000 Mcf was produced from Well B-5 on lease OCS-0788 which is deeper than 15,000 feet below mean sea level, and that the remainder was produced from depths above 15,000 feet below mean sea level.

3/ MMS reports that Texaco valued gas produced during the audit period according to the prices established by the FPC in various opinions (Nos. 598, 699, 699H, 749 and 770A).

market. OIG recomputed the value of gas transported to Texaco's Eagle Point refinery according to the "highest allowable interstate prices" established in various opinions of the FPC (Nos. 598, 699 and 699H, and 770 and 770A) for the audit period and recalculated total royalties due. Id. 4/ Based on this recalculation, OIG determined that Texaco had underpaid royalties in the amount of \$339,183.32 for Eagle Point gas. In addition to recommending assessment of the additional royalty, OIG recommended that Texaco be directed to adopt the "highest allowable interstate price" method for valuing future Eagle Point gas.

In his November 1979 letter-order, the Oil and Gas Supervisor, relying on the Audit Report, required Texaco to pay additional royalties within 30 days of receipt of the letter-order, recompute royalties due on Eagle Point gas for the period "August 1978 to date" in accordance with the valuation method set forth in the Audit Report and pay additional royalties due within 45 days of receipt of the letter-order and, finally, adopt that valuation method for future Eagle Point gas.

By letter dated December 26, 1979, Texaco appealed the Oil and Gas Supervisor's November 1979 letter-order only to the extent it concerned the assessment of royalties based on the valuation of Eagle Point gas. Texaco argued that it was proper, under 30 CFR 250.64 (1979), to value Eagle Point gas according to the price set by the December 1969 gas purchase contracts and actually received for gas sold to Transco where gas transported to the refinery would have otherwise been required to be sold to Transco under the contracts and was, thus, not available for sale on the interstate market.

After considerable deliberation, the Director, MMS, issued a decision in June 1986 affirming the Oil and Gas Supervisor's November 1979 letter-order. The Director stated that, in determining the proper value of Eagle Point gas, MMS was not limited to the price set by the December 1969 gas purchase contracts, especially where that gas was "not committed" to the contracts and was "not sold in interstate commerce," unlike gas sold to Transco (Decision at 8). He concluded that MMS could, after it had reviewed

4/ The Government's evaluation in this case was explained in a Oct. 30, 1985, memorandum from the Office of the Solicitor to the Chief, Division of Appeals, MMS, as follows:

"Thus, in Texaco's appeal, it argues that the Texaco-Transco contract rate should be used to value the Eagle Point refinery gas which would be the regulated ceiling rate of the corresponding vintage. However, OIG valued the Eagle Point refinery gas at the highest regulated rate of any gas regardless of the vintage under the assumption that the gas was not regulated (it was not sold in interstate commerce) and accordingly could not be valued at a rate higher than the appropriate regulated rate. 5/

5/ For example, on wells spudded before Jan. 1, 1973, FPC 598 set the price to \$.26 per Mcf. OIG used FPC 699 rates (which were approximately \$.50 per Mcf) to value the gas. FPC 699 set value on gas from wells spudded after Jan. 1, 1973. " (Memorandum at 3-4).

the prices received for gas sold from leases "near or adjacent to the Texaco leases," properly value the gas transported to Texaco's Eagle Point refinery pursuant to 30 CFR 250.64 (1979) according to the "highest price paid" which was "tantamount to" the highest allowable interstate price established by the FPC. Id. at 9. Texaco has appealed from that decision.

During the audit period in question the applicable regulation, 30 CFR 250.64 (1979), provided:

The value of production, for the purpose of computing royalty, shall be the estimated reasonable value of the product as determined by the supervisor, due consideration being given to the highest price paid for a part or for a majority of production of like quality in the same field or area, to the price received by the lessee, to posted prices, and to other relevant matters. Under no circumstances shall the value of production of any said substance for the purposes of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary. In the absence of good reason to the contrary, value computed on the basis of the highest price paid or offered at the time of production in a fair and open market for the major portion of like quality products produced and sold from the field or area where the leased lands are situated will be considered to be a reasonable value. [5]

In its statement of reasons for appeal (SOR), appellant contends that the price established in the December 1969 gas sales contracts constitutes a proper basis under 30 CFR 250.64 (1979) for valuing the production from appellant's OCS leases where this price was the "only price paid for any production not transported to and used at the Eagle Point refinery" (SOR at 5) and, thus, gave due consideration to the "highest price paid for a part or for a majority of production of like quality in the same field or area" in accordance with 30 CFR 250.64 (1979). Appellant argues that use of the highest allowable interstate price by MMS was not appropriate where appellant was legally obligated to deliver the gas "either under the gas

5/ Effective Dec. 13, 1979, the Department amended 30 CFR 250.64 (1979) to provide that the "value of production shall never be less than the fair market value," which value would be determined considering the highest price paid for a part or for a majority of like-quality products produced from the field or area, the price received by the lessee, posted prices, regulated prices and other relevant matters. 44 FR 61903 (Oct. 26, 1979). The Department subsequently redesignated the regulation 30 CFR 206.150, effective Aug. 5, 1983. 48 FR 35641 (Aug. 5, 1983). Effective Mar. 1, 1988, the Department significantly amended the regulations applicable to the valuation of oil and gas for royalty computation purposes. See 53 FR 1184, 1230 (Jan. 15, 1988). The regulations applicable to the valuation of gas for royalty computation purposes are currently codified at 30 CFR Subpart D (53 FR 1272 (Jan. 15, 1988)).

sales contract or the firm transportation agreement" and, thus, could not sell the gas to third parties (SOR at 5). Finally, appellant notes that MMS distinguished gas delivered under the sales contracts, which gas was subject to price regulation, and gas delivered under the firm transportation agreement, which gas was not subject to price regulation, as not production of "like quality," but then based the "value of unregulated gas on regulated prices." Id. at 6.

In its answer to appellant's SOR, MMS contends that it could value production from appellant's OCS leases at the highest obtainable interstate price, rather than the contract price, where it had the authority to determine the "reasonable value" of the gas, even when the gas was sold under an arm's-length contract. MMS asserts that, therefore, "gas disposed of under a non-arm's-length or no contract situation would not necessarily be valued at the contract price" (Answer at 4).

The sole question presented by this case concerns the proper valuation of Eagle Point gas. That question is clearly governed by 30 CFR 250.64 (1979), which was the applicable regulation in effect at the time of relevant production from appellant's OCS leases. That regulation required that oil or gas production be valued at its "estimated reasonable value." 30 CFR 250.64 (1979). It is now well established that the term "reasonable value" affords the Department considerable latitude in valuing oil or gas production for royalty computation purposes. Marathon Oil Co. v. United States, 604 F. Supp. 1375, 1382 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 107 S. Ct. 1593 (1987); Amoco Production Co., 78 IBLA 93, 96 (1983), aff'd, Amoco Production Co. v. Hodel, 627 F. Supp. 1375 (W.D. La. 1986), vacated and remanded, 815 F.2d 352 (5th Cir. 1987), cert. denied, 56 U.S.L.W. 3891 (U.S. June 28, 1988) (No. 87-372). 6/

In paying royalties, appellant valued Eagle Point gas at the price set by the December 1969 contracts for gas sold to Transco. In its November 1979 report, at page 6, OIG rejected that approach because appellant had no "legal commitment to deliver any gas to the refinery and, accordingly, always has had the option of selling this gas on the interstate market." In response thereto, appellant argued that no such option existed. We agree to the following extent.

Under the contracts, appellant committed all of its interest in recoverable gas reserves underlying the four OCS leases down to a vertical depth of 15,000 feet below mean sea level. This commitment was expressly subject to appellant's right to elect to deliver a portion of these reserves to Transco for transportation under the December 1969 transportation agreement, whereupon such "transportation volumes" were to be considered uncommitted. December 1969 Gas Purchase Contracts at 19. However, it is clear that, in

6/ The Fifth Circuit Court of Appeals ruled that the District Court did not have subject matter jurisdiction of Amoco's claim. Therefore, it vacated the District Court's decision and remanded the case to the District Court with instructions to transfer the case to the Claims Court. 815 F.2d at 368.

the absence of an election, the gas remained committed to the contracts and could not be sold on the interstate market. The exception is the 900,000 Mcf of gas produced during the audit period from Well B-5 on lease OCS-0788. That gas came from a formation lower than 15,000 feet below mean sea level. It, therefore, was not committed to the contracts, and Texaco had the option of selling it on the interstate market.

We note that in a decision styled Texaco, Inc., GS-126-O&G, approved by the Secretary of the Interior on March 28, 1979, the Acting Director, Geological Survey, concluded at page 4 that, in accordance with 30 CFR 250.64 (1978), the proper method for valuing gas used as fuel at a Texaco refinery was the "highest price Texaco could have obtained on the interstate market if each month's production had been offered as a separate or new sale," rather than the contract price for other gas sold from the same lease. That case is clearly distinguishable from the present situation. As stated in that decision at page 2:

The audit report, incorporated into the Supervisor's decision, takes the position that the gas used by Texaco as plant fuel should have been valued on the basis of the highest obtainable interstate price and not the weighted average price.

The reasoning for this position is that Texaco had no contractual obligation to deliver residue gas to its Port Arthur Refinery for use as fuel. Since it had no obligation to provide fuel to the refinery, it always had the option of selling the residue gas on the interstate market. Since Texaco always had the option of selling the residue gas on the interstate market, the correct value of the residue gas is the highest price Texaco could have obtained on the interstate market if each month's production had been offered as a separate or new sale. [Emphasis added.]

In this case, however, Texaco did not have such an option. 7/ That fact is well documented in the file.

In a March 10, 1980, memorandum to the Chief, Conservation Division, Geological Survey, at page 2, the Oil and Gas Supervisor stated that the "problem arises in that the lessee had a contractual obligation to deliver its residue gas as plant fuel and thereby could not offer this gas for sale

7/ Our recent decision in Sun Exploration & Production Co., 104 IBLA 178 (1988), is likewise distinguishable. In that case Sun sold gas to Transco under a contract and also Transco transferred gas to Sun's refinery under a transportation agreement. Sun attempted to value the refinery gas for royalty purposes according to the Transco contract price. MMS rejected that valuation. Sun's contention on appeal, which the Board rejected, was that the contract valuation should obtain because any gas not transferred to the refinery would be covered by the Transco contract. However, the record did not support Sun's contention and the Board affirmed the MMS decision. The record showed, as in Texaco, Inc., GS-126-O&G, that the company always had the option of selling the residue gas on the interstate market.

at the highest obtainable interstate price." Also, in a February 3, 1981, memorandum to the Deputy Division Chief, Offshore Minerals Regulation, Conservation Division, Geological Survey, the Acting Associate Solicitor, Division of Energy and Resources, specifically stated that OIG's rationale that appellant had the option of selling Eagle Point gas on the interstate market was a "fiction."

[1] The Department is not bound by 30 CFR 250.64 (1979) to value production according to the contract price, even though it constitutes the "price received by the lessee" within the meaning of that regulation. Amoco Production Co. v. Hodel, 627 F. Supp. at 1379; Amoco Production Co., 85 IBLA 121, 128 (1985), appeal filed, Amoco Production Co. v. Hodel, No. 87-0243 (W.D. La. Feb. 4, 1987); see United States v. Ohio Oil Co., 163 F.2d 633, 641 (10th Cir. 1947), cert. denied, 333 U.S. 833 (1948). As the court observed in California Co. v. Udall, 296 F.2d 384, 388 (D.C. Cir. 1961), in order "[t]o protect the public's royalty interest [the Secretary] may determine that minerals are being sold at less than reasonable value." Similarly, we said in Amoco Production Co., 78 IBLA at 100, that the "regulations clearly allow the superimposition of a value determination based on actual market conditions on any sales price which falls below the standard of reasonableness." Clearly, what was contemplated by the regulation was that the royalty due the Government should be based on the fair market value of oil or gas production and that such value might differ from the actual price at which the oil or gas was sold. 8/ See California Co. v. Udall, 296 F.2d at 388; Continental Oil Co. v. United States, 184 F.2d 802, 817 (9th Cir. 1950); Marathon Oil Co. v. United States, 604 F. Supp. at 1382; Huskey Oil Co., A-27168 (Nov. 26, 1956). In such circumstances, the Secretary was given the broad discretion to establish the price for royalty purposes and his discretion was tempered only by the standard of reasonableness. 9/

In Texaco, Inc., GS-126-O&G, the Acting Director, Geological Survey, concluded, with Secretarial approval, that gas used as fuel at a Texaco refinery should be valued at the highest obtainable interstate price "[s]ince Texaco always had the option of selling the * * * gas on the interstate market" (Decision at 2). As noted above, no such option existed in this case for the majority of the Eagle Point gas. We find that MMS should have accepted the contract prices for that part of the Eagle point gas recovered from a formation at a depth of 15,000 feet below mean sea level or higher. If, in fact, the contract prices did not represent fair market value for the

8/ Section 18(a)(4) of OCSLA, as amended, 43 U.S.C. | 1344(a)(4) (1982), which was enacted prior to the December 1979 amendment of 30 CFR 250.64 (1979), specifically provides that "[l]easing activities shall be conducted to assure receipt of fair market value for the lands leased and the rights conveyed by the Federal Government" in connection with OCS leases. See Watt v. Energy Action Educational Foundation, 454 U.S. 151, 162 (1981).

9/ In Amoco Production Co., 78 IBLA at 98, the Board stated that "there must be a reasonable basis for the determination to set value other than at the actual price received." However, we acknowledged that proceeds of a sale and fair market value might not be interchangeable when arriving at value of production. Id.

gas sold to Transco, they should not have been accepted. However, they were accepted. It is only for the Eagle Point gas that the contract prices were rejected. We cannot find that it was reasonable to reject those prices for gas which, but for transfer to the refinery, would have been required by the contract to have been sold to Transco, and it was error to do so. Therefore, the Eagle Point gas recovered from formations at 15,000 feet below mean sea level and higher could properly be valued for royalty purposes at the contract prices charged by Texaco to Transco. To the extent the Director's June 1986 decision holds otherwise, it is reversed.

However, the record shows that 900,000 Mcf of gas produced during the audit period from Well B-5 on lease OCS-0788 from a formation lower than 15,000 feet below mean sea level was transported to Texaco's Eagle Point refinery. That gas was not subject to the Transco purchase contracts. Therefore, the Government could properly set the value of that gas for royalty purposes at the highest obtainable interstate price, as it did for the gas involved in Texaco, Inc., GS-126-O&G.

In his decision the Director concluded that "record evidence" demonstrated that the "'highest price paid' was tantamount to the FPC opinion with the highest rate provision" (Decision at 9, emphasis added). This statement presumably refers to a preceding statement by the Director that the Oil and Gas Supervisor had "reviewed various prices received for gas from leases near or adjacent to the Texaco leases." Id. at 8. In effect, the Director found that the highest allowable interstate price, established by the FPC, was more or less equivalent to the highest price paid with respect to other sales of gas.

The "record evidence" to which the Director refers in his June 1986 decision was clearly generated in response to the Acting Associate Solicitor's February 1981 memorandum. In that memorandum, the Acting Associate Solicitor specifically stated that the Geological Survey (now MMS) could strengthen its decision to use the highest obtainable interstate price with evidence developed by the Oil and Gas Supervisor that, during the audit period, the price of like quality gas sold interstate from the field or area of appellant's four OCS leases or sold intrastate from the nearest onshore field or area was "generally higher than the highest interstate price" (Memorandum at 2).

In an October 15, 1985, memorandum, at page 3, the Regional Manager, Houston Regional Compliance Office, reported to the Associate Solicitor that the Oil and Gas Supervisor had reviewed various monthly prices received for gas from leases near or adjacent to appellant's four OCS leases. Attached to the memorandum was "Exhibit II" which set out a schedule of prices reported for gas sold from several OCS leases adjacent to appellant's leases, either in the same field or area, for the months November 1976, February, June, and December 1977, and March and May 1978. In each case, the reported price exceeded the highest allowable interstate price then permitted by the FPC.

Thus, the only evidence of record, although it does not cover the entire audit period, shows that prices received for gas produced from leases

adjacent to appellant's leases exceeded the highest allowable interstate price used by MMS to value Eagle Point gas. The record fails to support the Director's conclusion that "the 'highest price paid' was tantamount to the FPC opinion with the highest rate provision" (Decision at 9). At all times for which there is record evidence the "highest price paid" was greater than the FPC opinion prices. Such evidence would support a greater value for production. Therefore, we set aside the Director's June 1986 decision as it relates to the 900,000 Mcf of gas produced during the audit period from a formation lower than 15,000 feet below mean sea level and remand for a redetermination of the appropriate value of that gas for royalty purposes. 10/

Accordingly, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 CFR 4.1, the decision appealed from is reversed in part and set aside in part and the case is remanded to MMS for further action consistent herewith.

Bruce R. Harris
Administrative Judge

I concur:

Franklin D. Arness
Administrative Judge

10/ We do not mean to imply that use of FPC opinion prices is improper. Clearly, such prices may be utilized by MMS for valuation purposes; however, where MMS does rely on them on the basis that they are "tantamount" to the "highest price paid" within the meaning of 30 CFR 250.64 (1979), the record must support that reliance.